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COMMENTS

THE STATUTORY SCHEME OF CORPORATE REORGANIZATION UNDER THE 1954 INTERNAL REVENUE CODE AND THE PROPOSED AMENDMENTS THERETO*

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I. INTRODUCTION

The reorganization provisions of the Internal Revenue Code¹ cover nearly every corporate transformation and are perhaps "the most complex provisions of the Code."² The policy behind these provisions is that if, after a reorganization, there is no real change in substance, that is, no fundamental change in the relation between the shareholder and the corporation, then there will be no recognition of gain or loss for tax purposes at that time.³

This article will endeavor to analyze the reorganization provisions of the 1954 Code and the 1958 proposed amendments to Subchapter C. We will be concerned primarily with sections 368, 354(a) and (b), 356(a), (b), and (d), 357 and 361 and will include a discussion concerning the "basis" provisions contained in sections 358 and 362.

Under the 1954 Code, section 368(a)(1)⁴ states that a reorganization means any one of the following:

- (A) A statutory merger or consolidation,
- (B) The acquisition by one corporation of the stock of a second corporation.

The acquisition must be solely for all, or a part of, the first corporation's voting stock, and, immediately after the acquisition, the first corporation must be in control of the second corporation. This is the rule, regardless of

*This article is a revision of a manuscript prepared for the tax seminar on corporations at the University of Miami School of Law.

1. The text of the pertinent provisions of the 1954 Internal Revenue Code may be found in Appendix A; the text of the proposed amendments may be found in Appendix B.

2. SURREY & WARREN, *FEDERAL INCOME TAXATION* 1267 1955 ed. (hereinafter referred to as SURREY & WARRAN).

3. *Ibid.*

4. INT. REV. CODE OF 1954, § 368(a)(1)(A)-(F) (hereinafter to be referred to by section).

whether the first corporation controlled the second immediately before the acquisition.

(C) The acquisition by one corporation of substantially all of the properties of a second corporation.

For these properties, the first corporation may give either its own voting stock ("solely for voting stock" requirement here as in the "B" reorganization), or a part thereof; or the voting stock, or a part thereof, of its parent corporation which is in control of the acquiring corporation. The acquiring corporation may assume a liability of the acquired corporation or take property of the latter corporation which is subject to a liability.

(D) A transfer by one corporation of all, or a part of, its assets to a second corporation if, immediately after the transfer, the first corporation or one or more of its shareholders or any combination thereof is in control of the second corporation.

A further requirement is that the stock and securities received in the exchange must be distributed by the first corporation to its shareholders pursuant to section 354, 355, or 356. Under the rule of section 354(b)(1)(B) the transferor must liquidate in the "D" reorganization.

(E) A recapitalization; or

(F) A mere change in identity, form, or place of organization, however effected.

II. DEFINITION OF A REORGANIZATION: SIX TYPES

The most important of all the code sections dealing with reorganizations is section 368. The first part of section 368(a) deals with the six types ("A-F") of reorganizations. Immediately following the treatment of these six reorganizations will be a comprehensive chart encompassing the vital requirements of each type of reorganization.

A. The "A" Reorganization (statutory merger)

1. PRESENT LAW

The first type of reorganization is termed the "A" reorganization and involves a statutory merger or consolidation. The types of mergers and consolidations permitted by the present law are those effectuated in accordance with state corporation laws or corporation laws of the United States or a territory or the District of Columbia.⁵ A consolidation takes place where two corporations, A and B, combine to form a new corporation, C.⁶ However, in a merger of A and B either A will be absorbed by B or B will be absorbed by A, and the resulting corporation will be B

5. Treas. Reg. § 1.368-2 (1955).

6. SOWARDS, COMMENTS ON CORPORATIONS & PARTNERSHIPS 508 (1958).

or A as the case may be.⁷ There is no requirement in an "A" reorganization that the consideration received in the exchange be "solely" voting stock of the acquiring corporation.⁸

Besides compliance with statutory requirements of effecting a consolidation or merger there are two additional requirements that the courts have evolved that must be met in order to effect a tax free reorganization. They are: (1) a "business purpose" and, (2) "continuity of interest." As for the "business purpose,"⁹ it is considered satisfied if the purpose or motive of the reorganization is to create either more efficiency or economy in the area of management.¹⁰ This test is used mainly where there is a parent-subsidary relationship.¹¹

The "continuity of interest" test was set forth in *Southwest Natural Gas Co. v. Commissioner*¹² where the court insisted that it must be shown that:

[T]he transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and, such retained interest represents a substantial part of the value of the property transferred.

In the *Gregory*¹³ case, a taxpayer who was the sole shareholder in United, wanted Monitor's appreciated stock, held by United, without dividend consequences. She created Averill corporation and United transferred one thousand shares of Monitor to Averill for all of Averill's shares. These shares were to go directly to the taxpayer. Averill then dissolved and the assets, the Monitor shares, went to the taxpayer who was the sole shareholder. The Court held that this was a sham since Averill had no "business purpose." Similarly, in the *Pinellas*¹⁴ case the Court held that a transfer of assets in exchange for cash and short term notes could not qualify as a reorganization. This was not sufficient to meet the "continuity of interest" test. To meet this test there must be a genuine intention on the part of those changing the corporate form of business to continue the business in the altered form.¹⁵ If the "continuity of interest" test is not met, then the transaction will be considered a sale and not a reorganization.¹⁶

7. *Ibid.*

8. 3 MERTENS, LAW OF FEDERAL INCOME TAXATION 307 (1957) (hereinafter referred to as 3 MERTENS).

9. *Id.* at 309.

10. Rev. Rul. 55-45, 1955-1 CUM. BULL. 34. See Rev. Rul. 58-68, 1958-1 CUM. BULL. 183.

11. 3 MERTENS 310.

12. 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951). See also *Eric County United Bank*, 21 T.C. 636 (1954).

13. *Gregory v. Helvering*, 293 U.S. 465 (1935).

14. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

15. Rev. Rul. 56-330, 1956-2 CUM. BULL. 204. See Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183, 1185 (1957).

16. See Ralph M. Heintz, 25 T.C. 132 (1955).

If a transaction does not qualify as a section 368(a) reorganization, then the shareholders of the merged corporation, *i.e.*, that corporation which is absorbed, will receive capital gain treatment at that time based on the excess of the consideration received from the merging, continuing corporation over the cost of their stock.¹⁷

2. PROPOSED "A" REORGANIZATION

Under the proposals, the "A" reorganization is retained as a separate category, and in setting out the "continuity of interest" requirement the transferor-corporation's shareholders must: 1) receive their consideration in form of the transferee's stock to extent of 66 2/3% thereof,¹⁸ or 2) to control the acquiring corporation immediately after the transfer. The test of control here is 50% ownership of all classes of stock.¹⁹

The main proposed change is that in the "A" (statutory merger) and, incidentally, the "C" (acquisition of assets for stock) reorganizations, the consideration received may be either voting or non-voting stock.²⁰ In the case of the "A" reorganization this had previously been the case, although it would appear that the 66 2/3% requirement might be less than that previously required. The advisory committee believed that economic "continuity of interest" was of greater import than the right to vote for directors or for corporate policies.²¹

B. The "B" Reorganization (stock for stock)

1. PRESENT LAW

The second type of reorganization described in section 368(a) is the "B" reorganization which takes place when one corporation acquires the stock of a second corporation solely for all or a part of its voting stock. For example, suppose that corporation A desired to acquire corporation B. It may do so under present law only by acquiring the stock of B in exchange solely for all or a part of A's voting stock. However, there is a requirement that immediately after the exchange the acquiring corporation must be in control of the other corporation. The fact that the

17. McDonald & Willard, *Tax Free Acquisitions & Distributions*, N.Y.U. 14TH INST. ON FED. TAX. 868 (1956) (Hereinafter referred to as McDonald & Willard.)

18. H.R. REP. No. 4459, 86th Cong., 1st Sess. (1959) (hereinafter referred to as "New §"), New § 368(a)(1)(A)(i); "66 2/3 percent or more of the consideration received by the shareholders of the transferor corporation (in exchange for stock in such corporation), measured by fair market value, consists of stock of the acquiring corporation."

19. New § 368(a)(1)(A)(ii): "immediately after the transfer the shareholders of the transferor corporation are in control (substituting a 50 percent requirement for the 80 percent requirement contained in subsection (c)) of the acquiring corporation."

20. Advisory Group on Subchapter C of the Internal Revenue Code of 1954, *Revised Report on Corporate Distributions and Adjustments to Accompany Subchapter C Advisory Group Proposed Amendments, as Revised § 26*, p. 75-6 (hereinafter referred to as Proposed Amendments.)

21. *Id.* at 76.

acquiring corporation already owned part of the other corporation's stock, or already controlled it, does not affect the transaction. Control according to section 368(c) is defined as at least 80% of the voting stock plus 80% of the total ownership of the other classes of stock.²²

It is important to note that the "business purpose" and "continuity of interest" tests apply to this reorganization also.²³ If the provision is literally complied with, that fact, in and of itself, will satisfy the "continuity of interest" test.²⁴

The basic objective of the "B" (stock for stock) reorganization is to effect an amalgamation or joinder of corporations by acquiring a "controlling" stock interest in the acquired corporation.²⁵ Likewise, in the "B" reorganization the acquisition of the acquired corporation's stock must be directly from its shareholders.²⁶ If a plan of reorganization is effected to acquire another corporation's stock but part of the plan, and its real intent, calls for the acquisition of the stock merely to be a step toward acquisition of the other corporation's assets then the transaction probably would fail to qualify as a "B" reorganization.²⁷ Such a plan might qualify as a "C" (acquisition of assets for stock) reorganization.

In the 1954 Code it was provided that "whether or not such acquiring corporation had control immediately before the acquisition," the "B" reorganization provision would not be violated merely by a subsequent acquisition of the transferor's stock. The purpose of this provision was to permit for the first time what is known as "creeping control."²⁸ "Creeping control" takes place where a corporation acquires some stock and later in a *separate transaction* acquires a sufficient amount to constitute the 80% requirement when added to the previous acquisition.²⁹ The fact that the first acquisition was for cash will not destroy the reorganization unless the court treats the two transactions as one.³⁰ If the court does treat the two transactions as one, the reorganization would be destroyed because the "solely for voting stock" requirement would have been violated.³¹ If a transaction results in the acquisition of 80% of the stock but as part of that same transaction additional stock is acquired for cash, it would appear that the section has been complied with. However, in the *Hubert E. Howard*³² case the opposite result was reached.

Another interesting problem takes place when the transaction involves a series of acquisitions, all for voting stock, but the transaction covers

22. Compare *Barker v. United States*, 200 F.2d 223, 231 (9th Cir. 1952).

23. 3 MERTENS 317.

24. *Id.* at 317-18.

25. *Id.* at 318.

26. *Id.* at 319.

27. *Id.* at 318.

28. SURREY & WARREN 1268.

29. McDonald & Willard 870.

30. *Id.* at 871.

31. *Ibid.*

32. 24 T.C. 792 (1955), *rev'd on other grounds*, 238 F.2d 943 (7th Cir. 1956).

a considerable period of time.³³ The Regulations solve this problem and require either a single transaction or a series of transactions, but they must not extend beyond a twelve month period.³⁴ In the "B" (stock for stock) reorganization it should be noted that the *Groman*³⁵ and *Bashford*³⁶ rule is still in effect.³⁷ That rule forbids the acquiring corporation to transfer effectively the stock it received to a controlled subsidiary. Also, it forbids a subsidiary to acquire that stock by giving voting stock of its parent.³⁸ In the "B" (stock for stock) reorganization control is needed immediately following the acquisition. The corporation may immediately thereafter divest itself of such control provided, of course, that such divestment was not required to be done at the time control was first obtained.³⁹

Finally, although the "B" reorganization provision⁴⁰ does not specify the amount of voting stock which must be given in the exchange, it is required that it must be approximately equal to the value of the acquired stock⁴¹ and at the same time satisfy the "continuity of interest" test.

2. PROPOSED "B" REORGANIZATION

Many of the problems existing under the "B" reorganization provisions in the 1954 Code have been remedied by the proposed amendments. Under the new provisions the "solely for voting stock" requirement has been eliminated. In fact, the advisory group in proposed section 368(d) has provided that rights to acquire stock are "stock" within the "continuity of interest" test.⁴² This revolutionary departure from past and present tax policy has been severely criticized.⁴³ Further, each shareholder of the transferor corporation is dealt with separately on his own particular exchange with the acquiring corporation.⁴⁴ If at least 66 2/3% of the consideration received by the individual shareholder of the transferor consists of stock of the acquiring corporation, then, as to that shareholder, there will be no recognition of gain or loss.⁴⁵ This, however, is qualified by the new section 368(a)(1)(B)(ii) in that the acquiring corporation must either: 1) be in

33. McDonald & Willard 874.

34. Treas. Reg. § 1.368-2(C) (1955). See H.R. REP. NO. 1337, 83d Cong., 2d Sess. A. 132 (1954).

35. *Groman v. Commissioner*, 302 U.S. 82 (1937).

36. *Helvering v. Bashford*, 302 U.S. 454 (1938).

37. McDonald & Willard 876.

38. *Ibid.*

39. 3 MERTENS 323.

40. § 368(a)(1)(B).

41. 3 MERTENS 324.

42. New § 368(a)(1)(B)(i): "66 2/3 percent or more of the consideration received by the shareholder in exchange for such stock, measured by fair market value, consists of stock of the acquiring corporation."

43. New § 368(d): "Stock—For purposes of this part, except subsection (c) of this section, the term 'stock' includes rights to acquire stock."

44. Greene, *Proposed Definitional Changes in Reorganizations*, 14 TAX L. REV. 155, 163 (1959).

45. Proposed Amendments § 26, p. 78.

46. *Ibid.* This 66 2/3 percent requirement represents a change from the initial advisory group's recommendation of a 50 percent stock requirement.

control of the transferor immediately after the transfer (retaining the 80% requirement), or 2) acquire such control within six months thereafter.⁴⁷ This six month provision, in essence, is equivalent to a "statutory step-transaction" doctrine⁴⁸ (to be discussed later in detail). By this method the tax consequences to the taxpayer-shareholder would not be conditioned upon the way the corporation acquires the other stock from the other shareholders. However, the proposals would require the acquiring corporation to obtain control and the taxpayer to make his exchange pursuant to a plan by the acquiring corporation to attain one of three results: 1) a controlling interest, 2) "increase its ownership to the point of control," or 3) extend ownership beyond control.⁴⁹

The proposals permit the acquiring corporation to acquire part of the transferor's stock for its own stock, and part for cash. Even though it is all part of the same plan, the transaction would still be recognized as a "B" (stock for stock) reorganization. This would appear to be an extension beyond the present law,⁵⁰ which as was pointed out⁵¹ would ordinarily destroy the reorganization.

Finally, and perhaps the most important change is the equalization of the "B" reorganization with the "A" (statutory merger) and "C" (acquisition of assets for stock) reorganizations so far as the *Groman* and *Bashford* rule is concerned. Under this proposal, which is located in section 368(e), the stock acquired by the acquiring corporation may be transferred to its controlled subsidiary, or the acquiring corporation may use the stock of its parent as consideration for the acquisition of the other corporation's stock.⁵²

C. The "C" Reorganization (acquisition of assets for stock)

1. PRESENT LAW

The third type reorganization is known as the "C" reorganization which takes place when one corporation solely for all or a part of its voting stock acquires substantially all the assets of another corporation.⁵³ For example, suppose that corporation A wishes to acquire corporation B's assets rather than merely controlling corporation B through acquisition of B's stock, in which latter case, the "B" reorganization would be the proper channel. Corporation A would exchange its voting stock (all or a part) or the voting stock of its parent for substantially all of corporation B's assets. This would effect a "C" reorganization. However, as in the other reorganizations, the "business purpose" test and "continuity of interest" test

47. *Ibid.*

48. Greene, *Proposed Definitional Changes in Reorganization*, 14 TAX L. REV. 155, 169 (1959).

49. Proposed Amendments § 26, p. 78.

50. *Ibid.*

51. *Ibid.* See also note 30 *supra*.

52. New § 368(e). See Appendix B.

53. See Rev. Rul. 55-59, 1955-1 CUM. BULL. 35.

must be complied with.⁵⁴ In this reorganization, as in the "B" (stock for stock) reorganization, the "continuity of interest" test will probably be met due to the "solely for voting stock" requirement.⁵⁵ In this reorganization the assets are acquired directly from the corporation, whereas in the "B" reorganization the stock is acquired from the shareholders.⁵⁶ The transferor corporation in the "C" (acquisition of assets for stock) reorganization may either: 1) continue its business in which case it will be a "shell" holding stock in another corporation similar to a "holding corporation," or, 2) it may distribute the transferee's stock to its shareholders.⁵⁷ As to the question of acquiring "substantially all the assets," it has been held that this is a question of fact in each case. In the *Artic Ice*⁵⁸ case 68% was held to be insufficient. Transfers of 90% and 85% have been held to satisfy the section.⁵⁹

In the discussion of the "B" (stock for stock) reorganization it was noted that there could be what is known as "creeping control." There is some doubt, however, as to whether there may be "creeping acquisition" under the "C" (acquisition of assets for stock) reorganization.⁶⁰ If the corporation acquiring the assets receives some for voting stock and later acquires other assets for cash or other property, then, if the two transactions are considered related steps as opposed to separate steps, the solely for voting stock requirement would be violated.⁶¹ Similarly, if some of the assets are transferred to one corporation while others are transferred to the second corporation as part of the exchange, it probably would not be a "C" reorganization. This would appear to violate the language of "the acquisition by one corporation . . . of substantially all the properties of another corporation. . . ."⁶²

An interesting problem arises where X corporation acquires all the stock of Y corporation for the principal purpose of later acquiring the assets of Y.⁶³ Through ownership of Y's stock, X may liquidate Y, thereby acquiring Y's assets. The problem here is whether this should be treated as a "C" reorganization (acquisition of assets for stock). In the *Mente*⁶⁴ case it was held that the above arrangement did constitute a "C" reorganization.

54. 3 MERTENS 238; McDonald & Willard 882.

55. McDonald & Willard 882.

56. 3 MERTENS 328.

57. *Id.* at 329.

58. *Artic Ice Mach. Co.*, 23 B.T.A. 1223 (1931), *modified by stipulation*, 67 F.2d 983 (6th Cir. 1933). See also *Pillar Rock Packing Co. v. Commissioner*, 90 F.2d 949 (9th Cir. 1937).

59. SURREY & WARREN 1269.

60. 3 MERTENS 335.

61. *Id.* at 336. See Rev. Rul. 54-396, 1954-2 CUM. BULL. 147.

62. 3 MERTENS 336. Cf. Rev. Rul. 54-107, 1954-1 CUM. BULL. 166.

63. 3 MERTENS 338.

64. *Mente & Co. Inc.*, 24 B.T.A. 401 (1931). See *Michigan Limestone & Chem. Co.*, 26 B.T.A. 928 (1932). See also *George Whittle & Co.*, 34 B.T.A. 1070 (1936); *Tennessee A. & G. Ry. Co.*, 13 T.C. 486 (1949), *aff'd*, 187 F.2d 826 (6th Cir. 1951); *WAGE, Inc.*, 19 T.C. 249 (1952); *Dana v. Commissioner*, 103 F.2d 359 (3d Cir. 1939); *Ahles Realty Corp. v. Commissioner*, 71 F.2d 150 (2d Cir.), *cert. denied*, 293 U.S. 611 (1934).

Another interesting facet of the "C" (acquisition of assets for stock) reorganization is the change in the 1954 Code overruling the *Groman* and *Bashford* rule discussed *supra*. Under the 1954 Code it is expressly provided that the consideration for the assets may be "all or a part of the voting stock of a corporation which is in control of the acquiring corporation." It would appear however that if the parent corporation acquires the assets for stock of the subsidiary and then transfers them to the subsidiary, this transaction would fail to qualify as a "C" (acquisition of assets for stock) reorganization.⁶⁵ Under section 368(a)(2)(C) it would be permissible for the parent acquiring corporation to transfer subsequently a part or all of the assets acquired to its subsidiary.

Under section 368(a)(2)(B) there is a 20% leeway with respect to "boot." If the acquired property of the other corporation has a fair market value which is at least 80% of the fair market value of all of the property of the other corporation and such 80% has been acquired solely for voting stock, then the remaining 20% or any part thereof may be acquired for consideration other than voting stock.⁶⁶ In these instances the parent must be in control of the subsidiary. Control is defined as 80% ownership of all classes of stock.⁶⁷

Section 368(a)(1)(C) provides that if the acquiring corporation assumes a liability of the transferor or takes property subject to a liability, such assumption is to be disregarded so far as "determining whether the exchange is solely for stock." However, although such assumption is to be disregarded it is only to be so disregarded as concerns the stock requirement, and section 368(a)(2)(B)(iii) would treat such assumption as "money paid for the property" or "boot."⁶⁸ In such a case, rather than the transferee assuming the liabilities, cash may be left in the transferor to pay off such liabilities without violating the conditions of the "C" (acquisition of assets for stock) reorganization.⁶⁹

Finally, it must be noted that if a reorganization falls within the "C" and "D" (transfer of assets for stock) categories, then under section 368(a)(2)(A) it is to be treated as if it were a "D" reorganization.

2. PROPOSED "C" REORGANIZATION

There are some very vital changes in the proposed amendments in the "C" (acquisition of assets for stock) reorganization category. Under

65. 3 MERTENS 340. See also Rev. Rul. 58-94, 1958-1 CUM. BULL. 194; but see Treas. Reg. § 1.368-2(d)(1) (1955).

66. Cf. Rev. Rul. 54-396, 1954-2 CUM. BULL. 147; 3 MERTENS 341; SURREY & WARREN 1269.

67. 3 MERTENS 342.

68. *Id.* at 344.

69. *Southland Ice Co.*, 5 T.C. 842 (1945). See also *Hubert E. Howard*, 24 T.C. 792 (1955), *rev'd on other grounds*, 238 F.2d 943 (7th Cir. 1956); *Roosevelt Hotel Co.*, 13 T.C. 399 (1949); *Westfir Lumber Co.*, 7 T.C. 1014 (1946).

the present law the transferor corporation (as was previously noted) may receive "boot" to the extent of 20% of the total consideration it receives. Also, the transferor corporation could remain a "shell" if it so desired. However, the proposals in section 368(a)(1)(C)(ii) require the transferor corporation to liquidate completely pursuant to the plan of reorganization unless the transfer is accomplished by a merger or consolidation.⁷⁰ The advisory group was of the opinion that by this method the transferor could not distribute the transferee's stock to its shareholders without tax and yet retain the "boot" for an ultimate liquidation at capital gain rates.⁷¹ There is no time limit set wherein the transferor must liquidate.⁷² However, there is a condition set forth that the liquidation must be carried out in pursuance of the plan of reorganization.⁷³

Perhaps the most important change that the proposals undertake in so far as the "C" reorganization is concerned is the abolishment of the voting stock requirement.⁷⁴ By no longer requiring the consideration for the assets to be "solely" voting stock, this, in effect, would appear to allow "creeping acquisition" (discussed *supra*) in the "C" (acquisition of assets for stock) reorganization, just as the 1954 Code allowed "creeping control" in the "B" (stock for stock) reorganization.

Another important change proposed is the elimination of any overlap between the "C" and "D" (transfer of assets for stock) reorganizations. In the present law it was noted that if there were any overlap, it was to be governed by the "D" rules. Under the proposals the overlap between the two reorganizations is destroyed. The destruction was accomplished by the simple process of making the two provisions mutually exclusive. "C" is made inapplicable where the transferor or its shareholders are in control of the transferee; "D" applies only where such control exists.⁷⁵

D. The "D" Reorganization (transfer of assets for stock)

1. PRESENT LAW

The fourth type of reorganization and perhaps the most complex reorganization is termed the "D" reorganization.⁷⁶ The "D" (transfer of

70. New § 368(a)(1)(C)(ii): "The transferor corporation is completely liquidated as a part of the plan pursuant to which the transfer of properties is made."

71. Proposed Amendments § 26, p. 79.

72. *Ibid.*

73. *Ibid.*

74. New § 368(a)(1)(C)(i): "66 2/3 percent or more of the consideration received in exchange therefor and distributed to the shareholders of the transferor corporation, measured by fair market value, consists of stock of the acquiring corporation."

75. New § 368(a)(1)(C)(iii): "neither the transferor nor any of its shareholders nor any combination thereof is in control (substituting a 50 percent requirement for the 80 percent requirement contained in subsection (c)) of the acquiring corporation immediately after the transfer." New § 368(a)(1)(D)(i): "immediately after the transfer the corporation whose properties are transferred, or one or more of its shareholders, or any combination thereof, is in control (substituting a 50 percent requirement for the 80 percent requirement contained in subsection (c)) of the acquiring corporation."

76. For a comprehensive treatment of the "D" reorganization, see Friedman, *Divisive Corporate Reorganizations Under the 1954 Code*, 10 TAX L. REV. 487 (1955). See also Greene, *supra* note 44, at 183-200.

assets for stock) reorganization is mainly one of corporate division as compared to the "A" (statutory merger), "B" (stock for stock), and "C" (acquisition of assets for stock) reorganizations which are concerned with corporate amalgamations.⁷⁷ The "D" reorganization has a dual purpose. It can be used to effect a division of a corporation into two component parts, or can be used to achieve a purpose similar to a recapitalization which is found in the "E" reorganization.⁷⁸ For the purposes of this paper the discussion of the "D" reorganization will be limited to its divisive tendencies.⁷⁹

For there to be a "D" reorganization it is necessary that a corporation transfer "all or part of its assets" to a second corporation. In this respect the "D" reorganization differs from the "C" (acquisition of assets for stock) reorganization since the "C" requires acquisition of "substantially all the properties" of the transferor. Further, in the "D" reorganization, immediately after the transfer, control of the transferee corporation must be in any one of the following: 1) the transferor, 2) one or more of its shareholders, or, 3) a combination of either. Control for this purpose is likewise defined as 80% ownership of all classes of stock.

Another condition in the "D" reorganization is that pursuant to the plan of reorganization⁸⁰ the consideration received, being stock and securities, must be distributed in a transaction qualifying under sections 354, 355, or 356. This is yet another distinguishing factor from the "C" (acquisition of assets for stock) reorganization. In the "D", unlike the "C", the consideration received need not be "solely voting stock."⁸¹

According to one author,⁸² the situation in a "D" (transfer of assets for stock) reorganization will, for section 368(a) purposes, be considered a reorganization in two instances: 1) if the transaction is a first step in the liquidation of the transferor corporation and it is transforming itself into the transferee in whole or in part, or, 2) the transferor is dividing itself into two component parts neither of which is to be controlled by the other. In this latter case the treatment of the shareholders is to be found in section 355,⁸³ which is not dealt with in this article.⁸⁴

The first interesting problem in the "D" (transfer of assets for stock) reorganization takes place when instead of a single transferor conveying

77. SURREY & WARREN 1270; Greene, *supra* note 44, at 183-84.

78. McDonald & Willard 883.

79. For a discussion of the use of the "D" reorganization as a "readjustment within a single corporation," see McDonald & Willard 883-891.

80. For a comprehensive treatment of the term "pursuant to a plan of reorganization," see Manning, *In Pursuance of the Plan of Reorganization: The Scope of the Reorganization Provisions of the Internal Revenue Code*, 72 HARV. L. REV. 881 (1959).

81. See, e.g., *Helvering v. Schoellkopf, Jr.*, 100 F.2d 415 (2d Cir. 1938).

82. SURREY & WARREN 1270.

83. *Id.* at 1274.

84. For a comprehensive treatment of section 355, see 10 TAX L. REV. 487, 493-506 (1945).

its assets to the transferee, two corporations do so. In such a case the "D" (transfer of assets for stock) reorganization does not appear to be applicable since section 368(a)(1)(D) refers to a transfer by "a corporation."⁸⁵ Similarly, assuming a single transferor, it has been set forth that the fact that one shareholder has control would not be sufficient in all cases to satisfy the "continuity of interest" test despite the fact that the Code provides that control must be in one or more of its shareholders.⁸⁶

Another interesting facet of the "D" area takes place where the transferor controlled the transferee prior to and subsequent to the exchange and hence no stock is received in the exchange. In such a case it was held that there was a "D" (transfer of assets for stock) reorganization.⁸⁷

It should also be mentioned that in the "D" reorganization as in the "B" (stock for stock) and the "C" (acquisition of assets for stock) reorganizations under the proposals, "creeping control" is permissible.⁸⁸

Finally, if there is any overlap between a "D" and "C" reorganization the rules of section 368(a)(2)(A) make the "D" (transfer of assets for stock) reorganization rules applicable.

2. PROPOSED "D" REORGANIZATION

The present law provides that it is not mandatory for the transferor to liquidate but merely requires that it distribute the stock or securities that it receives in a transaction qualifying under section 354, 355, or 356.⁸⁹ However, under the proposals, liquidation is mandatory.⁹⁰ The advisory group stated that this would prevent the transferor from retaining any assets and prevent the "split-up."⁹¹ The "split-up" takes place when a corporation in return for the transfer of all of its assets to two separate corporations receives in exchange a controlling stock interest in each and subsequently liquidates.⁹² This proposal is designed to prevent the shareholders of the transferor corporation from converting what is ordinary income into capital gains⁹³; i.e., under present law "boot" distributions can be retained by the corporation for future distribution as capital gain in complete liquidation under section 331.

85. 3 MERTENS 356. See *Ericsson Screw Mach. Prod. Co.*, 14 T.C. 757 (1950).

86. See Cohen, Silverman, Surrey, Tarleau & Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations & Reorganizations*, 68 HARV. L. REV. 393, 419 (1955).

87. *Camp Wolters Enterprises, Inc.*, 22 T.C. 737 (1954); *aff'd*, 230 F.2d 555 (5th Cir. 1956); *Peck & Peck*, 42 B.T.A. 651 (1940).

88. 3 MERTENS 363.

89. Proposed Amendments § 26, p. 80.

90. New § 368(a)(1)(D)(ii): "the corporation whose properties are transferred is completely liquidated as a part of the plan pursuant to which the transfer is made (whether such complete liquidation precedes, accompanies, or follows the transfer)."

91. Proposed Amendments § 26 p. 80.

92. Greene, *supra* note 44, at 189.

93. *Id.* at 193.

Perhaps the most important change recommended is to prevent any overlap between the "D" reorganization and section 355.⁹⁴

The last change is the reduction of the amount of control needed. Control has been reduced from 80% ownership of all classes of stock to 50%.

E. The "E" Reorganization (a recapitalization)

1. PRESENT LAW

The fifth type of reorganization is known as the "E" reorganization and is termed a "recapitalization." The term "recapitalization" is not used in its technical sense,⁹⁵ but rather it is a reshuffling or readjustment of the capital structure within the confines of a single corporation.⁹⁶ As such, it differs from the previous four reorganizations since, here, only a single corporation is involved.⁹⁷ The main concern whenever a "recapitalization" is present is to insure that this is not used as a device to distribute earnings which should be taxed as a dividend. In *Commissioner v. Estate of Bedford*,⁹⁸ a company sought to recapitalize when it found it could not legally distribute dividends to its stockholders. Deceased's executor turned in decedent's stock for other stock and cash. The Court held that this was in effect a distribution of a dividend and taxable as such, because of the presence of current earnings.

In the "E" (recapitalization) reorganization the "business purpose" test (discussed *supra*) is also applied. For example, in the *Bazely*⁹⁹ and *Adams*¹⁰⁰ cases the taxpayer owned a family corporation and exchanged \$100 par value shares of stock for no par shares and certain debentures. The Court held that the debentures were merely a means to distribute corporate earnings and as such there was no "business purpose."

However, in the *Wolf Envelope Company*¹⁰¹ case the court found that although there was an earned surplus of over \$300,000, there was a real "business purpose" since voting control of the corporation was shifted and the managing shareholders entrenched their position.

A good test to determine if the "recapitalization" will be given non-tax consequences is to look at the situation of the shareholders and

94. New § 368(a)(1)(D)(iii): "no part of such plan constitutes a distribution of stock or securities to which section 355 (or so much of section 356 as relates to section 355) applies."

95. *Bazely v. Commissioner*, 331 U.S. 737 (1947).

96. *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942). See also example contained in Treas. Reg. § 1.368-2(e) (1955); Rev. Rul. 56-654, 1956-2 CUM. BULL. 716.

97. SURREY & WARREN 1271.

98. 325 U.S. 283 (1945). See Darrell, *The Scope of Commissioner v. Bedford's Estate*, 24 TAXES 266 (1946).

99. *Bazely v. Commissioner*, 331 U.S. 737 (1947).

100. *Adams v. Commissioner*, 331 U.S. 737 (1947).

101. 17 T.C. 471 (1951), *dismissed & aff'd without opinion*, 197 F.2d 864 (6th Cir. 1952).

security holders after the exchange. If they are in substantially the same position in which they would be in if they had received a dividend distribution then a tax will be imposed.¹⁰²

In determining whether a dividend has been distributed, if the distribution is substantially disproportionate it would appear that there has been no dividend since generally dividends are distributed proportionately.¹⁰³

Even in recapitalizations there may be "boot" received by the shareholders. The amount of "boot" would be the excess of the principal amount of securities received, determined by their fair market value, over the principal amount of the securities surrendered, determined by the shareholder's basis.¹⁰⁴ The problem would still be whether such excess is to be given capital gain or ordinary tax treatment. This is dependent upon whether it has the effect of dividend distribution.¹⁰⁵

Originally the Commissioner contended that there was no "recapitalization" where securities were exchanged for securities.¹⁰⁶ This contention was rejected in the *Neustadt*¹⁰⁷ case. However, the exchange of securities for securities must involve securities in the same corporation to be a "recapitalization."¹⁰⁸ Based on this it would appear that the "continuity of interest" test is also required in the "E" reorganization. If that is so it would be doubtful whether there would be an "E" reorganization if, for example, stock or securities are surrendered for short term notes or even long term obligations. If, however, short term notes are exchanged for stock or securities it would appear that this would meet the "continuity of interest" test.¹⁰⁹

2. PROPOSED "E" REORGANIZATION

In the proposed amendments there is no change in the "E" (recapitalization) reorganization and even the wording of the section remains the same.¹¹⁰

102. 3 MERTENS 382.

103. 3 MERTENS 385.

104. *Id.* at 387.

105. *Ibid.*

106. *Id.* at 389.

107. *Commissioner v. Trust of Neustadt*, 137 F.2d 528 (2d Cir. 1942), *affirming* 43 B.T.A. 848 (1941). Followed in *Conestogo Transp. Co.*, 17 T.C. 506 (1951); *Margaret Washburn Hunt*, 18 P-H Tax Ct. Mem. ¶ 49,245 (1949); *Henry H. Sheip Mfg. Co.*, 18 P-H Tax Ct. Mem. ¶ 49,184 (1949); *Walter Backrach*, 18 P-H Tax Ct. Mem. ¶ 49,092, *aff'd*, 182 F.2d 261 (7th Cir. 1950); *Mutual Fire, Marine & Inland Ins. Co.*, 12 T.C. 1057 (1949).

108. 3 MERTENS 389. See *Truman H. Newberry*, T.C. Memo. Op. Dkt. 2480 (1945).

109. *Compare Potter & Rayfield Inc.*, 15 P-H Tax Ct. Mem. ¶ 46,053 (1946) *with Commissioner v. Capento Sec. Corp.*, 140 F.2d 382 (1st Cir. 1944), *aff'g* 47 B.T.A. 691 (1942). For other successful business purposes, see 3 MERTENS 398-400.

110. See New § 368(a)(1)(E).

F. The "F" Reorganization

1. PRESENT LAW

The last type of reorganization is known as the "F" reorganization and in the 1954 Code it is expressed as "a mere change in identity; form, or place of organization however effected." This provision is the "catch all" provision.¹¹¹

2. PROPOSED "F" REORGANIZATION

In the proposals the "F" reorganization has remained as a separate category and the only change recommended was the addition of the words "of a corporation" after the word "organization" in the 1954 Code.¹¹²

111. 3 MERTENS 401.

112. See New § 368(a)(1)(F).

<p>"A" statutory merger or consolidation</p>	<p>1) must satisfy (implied requirements): a) continuity of interest test. b) business purposes test.</p>	<p>1) continuity of interest Consideration received by transferees must be 66 2/3 of transferee's stock.</p>
<p>"B" stock for stock</p>	<p>1) solely for voting stock requirement imposed. 2) acquiring corporation must, immediately after transfer, be in control of the transferor. Control is defined as 80% ownership of all classes of stock. 3) allows "creeping control". 4) <i>Groman</i> and <i>Bashford</i> rule in effect, (cannot use parent's stock to effect the transfer). 5) must satisfy (implied requirements): a) continuity of interest test. b) business purpose test.</p>	<p>1) solely for voting stock requirement abolished. 2) control requirement same as in 1954.</p>
<p>"C" acquisition of substantially all the transferor's assets for stock</p>	<p>1) consideration for assets must be all or a part of acquiring corporation's voting stock. 2) must acquire substantially (80%) all of the assets of the transferor. 3) <i>Groman</i> and <i>Bashford</i> rule not applicable. 4) no "creeping acquisition" permitted. 5) must satisfy (implied requirements): a) continuity of interest test. b) business purpose test.</p>	<p>3) <i>Groman</i> and <i>Bashford</i> rule now inapplicable. 4) continuity of interest test spelled out. 66 2/3% or more of the acquiring corporation's stock is given as the consideration for the transferor-shareholder's stock. 1) solely for voting stock abolished.</p>
<p>"D" transfer of all or a part of transferor's assets for stock</p>	<p>1) no solely for voting stock requirement. 2) after transfer the transferor must be in control of the transferee. Control is defined as ownership of 80% of all the classes of stock. 3) no need to transfer substantially all the assets as in the "C" reorganization. 4) stock received must be distributed to transferor's shareholders. 5) if any overlap between the "C" and "D" reorganizations, the "D" rules govern. 6) must satisfy (implied requirements): a) continuity of interest test. b) business purpose test.</p>	<p>2) "creeping acquisition" permitted due to destruction of voting stock requirement.</p>
<p>"E" a recapitalization</p>	<p>1) transaction takes place within confines of a single corporation. 2) must satisfy (implied requirements): a) continuity of interest test. b) business purpose test.</p>	<p>1) control reduced to 50%. 2) transferor must liquidate. 3) overlap between "C" and "D" destroyed.</p>
<p>"F" a mere change in identity; form, or place of organization however effected</p>	<p>1) must satisfy (implied requirements): a) continuity of interest test. b) business purpose test.</p>	<p>1) No change. 1) No change.</p>

III. SECTIONS 354 & 356: NON RECOGNITION OF GAIN OR LOSS AT THE SHAREHOLDER LEVEL

A. *Present Law Under Section 354.*

Section 354 deals with the tax treatment to the shareholder. In section 354(a)(1) the general rule is set forth that there will be no recognition of gain or loss to the shareholder if he exchanges stock or securities in one corporation for stock or securities in another corporation. There are two vital qualifications to non-recognition which must be complied with: 1) the exchange must be pursuant to a plan of reorganization, and 2) the stock and securities given up by the shareholder as well as those received by him in the exchange must be of a corporation which is a party to the reorganization.¹¹³

However, there is a provision contained in section 354(a)(2) which provides that the general rule will not apply if either: 1) the principal amount of the securities received exceeds the principal amount of the securities surrendered, or 2) securities are received but none are surrendered. If either of these two circumstances are present, then section 354(a)(1) is inapplicable and the shareholder will have to come under section 356 or else there will be a recognition of gain. Also, section 354(a) will not apply if any property other than stock or securities, is received by the shareholder.¹¹⁴

Section 354(a) is applicable in an "A" (statutory merger) and "B" (stock for stock) reorganization and in a "C" (acquisition of assets for stock) and "D" (transfer of assets for stock) reorganization but only if the plan of reorganization calls for the liquidation of the transferor corporation¹¹⁵ or as provided in section 354(b) for a "D" (transfer of assets for stock) reorganization.

Section 354(a) will not apply in a "D" reorganization unless two conditions are satisfied: 1) the transferee corporation acquires substantially all the assets of the transferor, and 2) the stock and securities received by the transferor as well as its other properties are distributed by the transferor in pursuance of the plan of reorganization. This dual requirement was imposed to avoid the situation under the 1939 Code where there could be a non-taxable exchange when the transferor effected a corporate division.¹¹⁶ If either of the above two requirements is not met then a corporate division is effected and section 355 must be satisfied.¹¹⁷ According to the Regulations,¹¹⁸ property may be retained by the transferor to satisfy existing liabilities without jeopardizing inapplicability of section 354(a).

113. 3 MERTENS 211-12.

114. SURREY & WARREN 1273.

115. *Id.* at 1272-1273.

116. 3 MERTENS 215-16.

117. SURREY & WARREN 1270, 1338.

118. Treas. Reg. § 1.354-1(a)(2) (1955).

B. *Present Law Under Section 356.*

Once it has been determined that section 354 is not applicable, the shareholder may *still* receive non-recognition. Although he is now "out of" section 354, section 356 may provide the benefit of nonrecognition. Section 356(a)(1) provides that "if section 354 . . . would apply *but for the fact*" that other property or money ("boot") is received besides the type of property permitted to be received in section 354, that is, stock or securities, then gain will be recognized but only to the extent of the "boot" received. "Boot" is defined by the section as "the sum of such money and the fair market value of such other property." However, in section 356(a)(2) if the exchange "has the effect of the distribution of a dividend" it will be treated as such to each distributee. The amount of the dividend can not be in "excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913." In other words, it will be treated as ordinary income, but if there is any gain above this amount it will be given capital gain treatment.

Section 356(c) provides that although gain is recognized to the extent of "boot," no loss from the exchange or distribution shall be recognized. Section 356(d) provides that securities permitted to be received under section 354 are not considered other property ("boot") subject to two qualifications: 1) if the principal amount of such securities received in a corporation, a party to the reorganization, exceeds the principal amount of such securities surrendered then the term "other property" ("boot") means only the fair market value of such excess, and 2) if nothing is surrendered then everything received is "other property" or "boot."

C. *Proposed Amendments to Section 354.*

In the proposed amendments to section 354 the principal change recommended is in the new section 354(a)(2)(B).¹¹⁹ The section presently is 354(b) which is designed to "deny nonrecognition of gain or loss" where a corporate division is effected pursuant to a "D" (transfer of assets for stock) reorganization which corporate division fails to qualify according to the rules of section 355.¹²⁰ The proposals state that the present statutory technique is defective in that it does not protect the rules of section 355 where "splitups" are concerned.¹²¹ A "splitup" takes place "where corporation A transfers part of its assets to subsidiary B and the remainder of its assets to subsidiary C, after which A dissolves, distributing to its stockholders the stock of B and C."¹²² Under the proposed section 354(a)(2)(B), if a "splitup" is accomplished then section 354(a)(1) would not apply and

119. New § 354(a)(2)(B): "in the case of an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), the corporation pursuant to the plan distributes to its shareholders in exchange stock in more than one corporation a party to the reorganization."

120. Proposed Amendments § 19, p. 63.

121. *Ibid*

122. *Ibid*.

there would be recognition of gain or loss unless the transaction qualified under section 355.¹²³ If it does so qualify under section 355 the reorganization provision would be inapplicable since the transaction would not fall into any of the six type of reorganizations ("A"-“F”).¹²⁴

However, one of the proposed amendments of section 356 is the new section 356(f).¹²⁵ This latter section provides that if, pursuant to a "D" (transfer of assets for stock) reorganization, stock in two corporations (both being parties to the reorganization), is distributed, then only the stock having the "highest fair market value" will be permitted to be received without recognition of gain or loss (or inclusion in income) to the shareholder.¹²⁶ According to the proposals, if a corporate division qualifies under section 355 (or so much of section 356 as relates to section 355) there would be no reorganization within the meaning of section 368(a) hence the reorganization provision would be wholly inapplicable.¹²⁷ In effect, corporate divisions have been removed completely from section 368. And if the division does not qualify under section 355 and "the transferor does not completely liquidate," no reorganization provision would apply and any distribution would probably be treated as a dividend.¹²⁸ If the transferor does liquidate completely, and accomplishes a "D" (transfer of assets for stock) reorganization, then the new sections 354(a)(2)(B) and 356(f) would apply and the shareholder will receive nonrecognition of gain or loss on the stock with the highest market value. The other stocks would be taxable as "boot."¹²⁹

D. Proposed Amendments to Section 356.

The principal change made in the proposals so far as section 356 is concerned is the reversing of the theory of *Howard v. Commissioner*.¹³⁰ In the *Howard* case petitioners owned common stock in a corporation which owned a majority of the common stock of a second corporation. A third corporation desired to take over petitioner's corporation and its subsidiary. As part of the transaction, shares were exchanged for shares and some of the parent's shares were paid for in cash by the third corporation. The federal circuit court held that the "solely for voting stock" requirement

123. New § 354(a)(2)(B).

124. Proposed Amendments § 19, p. 64.

125. New § 356(f): "If — (1) section 354 would apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D) but for the fact that (2) stock in more than one corporation a party to the reorganization is distributed by the transferor corporation pursuant to the plan, then, for purposes of subsection (a) and (b) of this section the stock so distributed (of any such corporation) which has a fair market value greater than the stock so distributed of any other such corporation or corporations shall be treated as property permitted by section 354 to be received without the recognition of gain or loss, and the stock of such other corporation or corporations shall be treated as other property."

126. Proposed Amendments § 19, p. 64, § 21, p. 70.

127. Proposed Amendments § 19, p. 64.

128. *Ibid.*

129. *Ibid.*

130. 238 F.2d 943 (7th Cir. 1956).

of section 368(a)(1)(B) was violated, and thus, there could be no reorganization. Further, the court held that, although the transaction was not a reorganization, section 356(a) applied and the taxpayer received non-recognition. The court based its holding on the fact that section 356(a) provides that if section 354 would apply but for the fact that "boot" was received then gain will be recognized to the extent of the "boot." Since this would have been a reorganization if not for the "boot," section 354 would have applied but for the fact such "boot" was received. In view of this reasoning the advisory group was of the opinion that it should be stated expressly that section 356(a) should apply only where a reorganization has been effected.¹³¹ In the proposals to section 356(a) the words "pursuant to a plan of reorganization" are added to the provision.¹³²

The proposals also seek to change the existing section 356(a) so far as "D" (transfer of assets for stock) reorganizations are concerned. In the existing law, the "boot" provisions operate only when stock or securities are exchanged for stock or securities.¹³³ However, it is noted that there have been cases where a shareholder in control of a corporation causes that corporation to transfer gratuitously its assets just before liquidation to a second corporation also controlled by him without receiving any stock or securities of the transferee. By this method there would be no "boot" provision applicable.¹³⁴ Also in the "reincorporation" area, a shareholder may receive assets of a liquidated corporation and part of those assets may be transferred as a capital contribution to another controlled corporation also without "boot" consequences.¹³⁵ The new section 356(a) (2)(B)(ii) would bring these transactions within the scope of the "boot" rule in spite of the fact that no stock or securities emanate from the transferee.¹³⁶

A further proposed amendment¹³⁷ to section 356 requires that if "boot" received in the exchange has the effect of interest income to the recipient,

131. Proposed Amendments § 21, p. 66.

132. New § 356(a)(1): "If — (A) section 354 would apply to an exchange made pursuant to a plan of reorganization (other than a reorganization under section 368(a) (1)(D)), or if section 355 or 371(b) would apply to an exchange, but for the fact that (B) the property received in the exchange consists not only of property permitted by section 354, 355, or 371(b) to be received without the recognition of gain or loss but also of other property or money, then no gain or loss shall be recognized to (and no amount shall be includible in the income of) the recipient except to the extent provided in subsection (b)."

133. Proposed Amendments § 21, p. 66.

134. *Ibid.*

135. *Ibid.*

136. *Id.* at 67. See example set out therein.

137. New § 356(b)(2)(A): "So much of such other property or money received in exchange for securities as has the effect of a payment of interest accrued thereon since the date of acquisition of the securities by the recipient (or by a person from whom the recipient acquired the securities in a transaction in which no gain or loss was recognized) shall, to the extent of its fair market value, be treated as interest income to the recipient as provided in section 61(a)(4)."

it should be treated as such.¹³⁸ Only the interest accrued from the time the taxpayer, who received the "boot," acquired the securities in a nonrecognition transaction, would be considered interest for purposes of the new section.¹³⁹

The last main proposed change of section 356 with which this article is concerned has been previously discussed in the treatment of section 354. That is, if, in a "D" (transfer of assets for stock) reorganization, stock in more than one corporation is distributed, only the stock having the highest fair market value may be received tax free.¹⁴⁰

IV. NONRECOGNITION TO CORPORATIONS: SECTION 361

A. *Present Law.*

The next main reorganization section is section 361. This section deals with nonrecognition of gain or loss to the corporation, not the shareholders. The section provides for nonrecognition of gain or loss where a corporation pursuant to the plan of reorganization exchanges properties *solely* for stock or securities in another corporation. Both corporations in such an exchange must be parties to the reorganization. The two principal requirements here are: 1) the need for a reorganization as provided in section 368(a), and 2) the exchange must be "an integral and essential part of the scheme and plan of the reorganization."¹⁴¹

It would appear from sections 354(b) and 361(b) that their purpose is, if possible, not to tax the corporation but to cause the "boot" to be distributed to the shareholders who will pay the tax. For example, in section 361(b) it is provided that if section 361(a) would apply but for the fact that property other than stock or securities is received, then if the recipient corporation distributes it in pursuance of the plan of reorganization, no gain to the corporation will be recognized.¹⁴²

138. *Commissioner v. Carman*, 189 F.2d 363 (2d Cir. 1951). Taxpayer prior to 1944 purchased \$25,000 worth of bonds of a railroad corporation. Interest was in default since 1933 and the railroad reorganized under the Bankruptcy Act. Pursuant to the reorganization taxpayer surrendered her old bonds and received in exchange: (1) \$10,000 new income bonds; (2) 150 shares 5% preferred (par \$100); (3) 116¾ shares of common and (4) \$5,672.25 in cash which "represented 'adjusted payments' . . . because of delay in consummating the reorganization" The court of appeals rejected the commissioner's contention that "the sum paid on the common stock 'had' the effect of the distribution of a taxable dividend" and hence taxable as ordinary income; *Commissioner v. Capento Sec. Corp.*, 140 F.2d 382 (1st Cir. 1944). Raytheon Production Corporation and Capento Securities Corporation were wholly owned subsidiaries of Raytheon Manufacturing Company. After Raytheon Production issued \$500,000 worth of bonds in 1929, Capento was organized in 1933 by Raytheon Manufacturing for the sole purpose of purchasing the bonds for \$15,000. Subsequently Raytheon Production needed a loan and the banks advised it to issue \$500,000 worth of preferred stock to Capento "solely" for cancellation of the bonds. The reason for this advice was to improve Raytheon Production's financial picture. The preferred stock issued was worth \$50,000. Capento showed a gain of \$35,000. The court of appeals held that this exchange was pursuant to a recapitalization, hence there was no recognition of gain.

139. Proposed Amendments § 21, p. 69.

140. *Id.* at 70. See New § 356(f).

141. 3 MERTENS 253. See John C. Shaffer, 28 B.T.A. 1294 (1933).

142. See INT. REV. CODE OF 1954, § 361(b).

Section 361(b)(1)(B) further provides that if such other property is not distributed then the gain will be recognized to the corporation. The gain would be recognized only to the extent of the money not distributed and the fair market value of the "other property" or "boot" not distributed. In section 361(b)(2) it is expressly provided that no loss shall be recognized on the exchange whether the transaction satisfies section 361(a) or not.

B. Proposed Amendments to Section 361.

The proposed amendments to section 361 recommend that section 361(b) be amended in the same respect as section 356(a) by adding the words "pursuant to a plan of reorganization."¹⁴³ The purpose of this change is to avoid the reasoning adopted in *Howard v. Commissioner*¹⁴⁴ by insisting that when stock is exchanged for stock and "boot" it *must* be "pursuant to a plan of reorganization" in order to insure nonrecognition of gain or loss. See discussion of the treatment of the *Howard* case *supra* under discussion of proposed amendments to section 356.

An important amendment would reduce the amount of gain that will be recognized to the corporation.¹⁴⁵ In existing law gain is recognized to the extent of "boot" which is retained by the corporation.¹⁴⁶ Under the proposals, however, such gain would be reduced by the amount of "boot" distributed.¹⁴⁷ The proposals give an example which explains this very well.¹⁴⁸ If the gain to the corporation is \$50,000 and "boot" received is \$70,000, and the corporation distributes \$15,000 of the "boot" pursuant to the plan of reorganization then the amount of "boot" retained is \$55,000 (\$70,000-\$15,000). Since this is more than the gain, the whole gain is recognized under existing law. However, under the proposals the gain recognized would be \$35,000, since gain is to be reduced to the extent of "boot" which is distributed.

V. "Boot"

The term "boot" has been used throughout this article since the term "other property and money," which is another way of saying "boot," appears in a number of the reorganization provisions. No article on reorganization could be complete without a treatment of this concept of "boot."

To define "boot" one must resort to the reorganization sections themselves, and according to those sections it means "other property or money."¹⁴⁹ "Boot" may be any of the following: 1) money 2) tangible property¹⁵⁰

143. Proposed Amendments § 24, p. 73.

144. 238 F.2d 943 (7th Cir. 1956).

145. New § 361(b)(1).

146. Proposed Amendments § 24, p. 73.

147. *Ibid.*

148. *Ibid.*

149. 3 MERTENS 564.

150. *Id.* at 565.

or, 3) cancellation of indebtedness which the recipient of the stock or securities owed.¹⁵¹

Where the acquiring corporation, a party to the exchange, assumes a liability or takes property subject to a liability, then such assumption or acquisition is "boot" to the other party except, of course, as provided in section 357 (to be discussed *infra*).¹⁵² The law in this area is clearly settled and unless the assumption of liabilities falls within one of the statutory provisions, this assumption will be given the same treatment to the transferor as if he had received money.¹⁵³ Similarly, if stock or securities are received in a corporation which is not a "party to the reorganization," then such will likewise constitute "boot."¹⁵⁴ Even if there are long term obligations received in an exchange, the "boot" provision may still be applicable.¹⁵⁵

Under section 354(a) and 356(d)(2)(A) (discussed *supra*) securities are not considered "other property," and there will be nonrecognition of gain or loss in two instances: first, where more securities are surrendered than are received or, second, some are surrendered and none received.¹⁵⁶ If the opposite is true, that is, more securities are received than surrendered or none are surrendered and some received, then "boot" will be recognized to the extent of the excess of the fair market value.¹⁵⁷ In these circumstances, fair market value controls where it differs from the principal amount.¹⁵⁸ Where the principal amount and the fair market value differ, what portion of the fair market value is to be attributed to this excess principal amount?¹⁵⁹ The Regulations¹⁶⁰ have provided a formula in such an instance.

"Boot" in certain cases may have the effect of a distribution of a dividend.¹⁶¹ For example, in section 356(a)(2) pursuant to a plan of reorganization "boot" may be distributed. If it is, and the effect of such distribution is the same as if a dividend has been distributed, then there will be ordinary income treatment given to such distribution of "boot." The "step transaction" (discussed *infra*, § IX) doctrine may also serve to destroy a purported reorganization; hence what would have been treated as "boot" would not get such treatment.¹⁶² For example, in the *Ralph M. Heintz*¹⁶³ case the court found that what had occurred was merely a

151. R. D. Walker, 34 B.T.A. 983 (1936); John L. Hawkinson, 23 T.C. 933 (1955), *aff'd*, 235 F.2d 747 (2d Cir. 1956).

152. 3 MERTENS 565.

153. *Id.* at 565-56.

154. *Id.* at 566.

155. *Bazely v. Commissioner*, 331 U.S. 737 (1947).

156. 3 MERTENS 567.

157. See § 356(d)(2)(B).

158. 3 MERTENS 568.

159. *Ibid.*

160. Treas. Reg. § 1.356-3(b) (1955).

161. 3 MERTENS 572.

162. *Id.* at 574.

163. 25 T.C. 132, 141 (1955).

sale of stock for cash and not a stock for stock plus cash transaction. Therefore, the cash would not get the "boot" treatment. In fact, the cash received was the consideration for the stock and could not be considered a taxable dividend, therefore the taxpayers were entitled to capital gain treatment.

Similarly, in one case¹⁶⁴ cash was distributed by the transferor out of its earnings just prior to an exchange of stock for stock. In that case the cash was not treated as "boot" received pursuant to a "B" (stock for stock) reorganization, but rather the distribution was regarded as a separate transaction and given dividend treatment.¹⁶⁵

In certain reorganizations, particularly the "C" (acquisition of assets for stock) and "D" (transfer of assets for stock), the transferor corporation may receive "boot" in the exchange and may subsequently distribute such "boot" to its shareholders.¹⁶⁶ If it does so pursuant to the plan of reorganization, then the transferor will receive nonrecognition treatment.¹⁶⁷ However, this nonrecognition treatment is applicable only if the "money or other property" that has been distributed by the transferor to its shareholders has been received from another corporation which meets the qualifications of a "party to the reorganization."¹⁶⁸

VI. ASSUMPTION OF LIABILITIES: SECTION 357

A. *Present Law.*

Section 357 provides that if taxpayer A in a stock for stock or assets for stock transaction receives the type of property *i.e.*, stock or security permitted nonrecognition under section 351, 361, 371, or 374, the fact that the transferee B in addition to the exempt consideration given assumes a liability of A or takes A's assets subject to a liability, such assumption will not be treated as "other property" or "boot" to A. Also, this assumption will not take the exchange out of the above provisions.¹⁶⁹ This, in essence, is an exception to the "boot" provision. This statement of the section however must be qualified by section 357(b). The qualifications are: 1) that in light of the transaction it must appear that the purpose of the assumption was not to effect a tax avoidance, and 2) the object of the assumption was to effect a "bona fide business purpose."¹⁷⁰ If such conditions are met then there will be no "boot" involved since the assumption will not be treated as other property or

164. Rev. Rul. 56-184, 1956-1 CUM. BULL. 190.

165. *Ibid.*

166. 3 MERTENS 580-81.

167. See INT. REV. CODE OF 1954, § 361(b)(1)(A), (B).

168. *Peir v. Commissioner*, 96 F.2d 642 (9th Cir. 1938). See also *Helvering v. Texas Penn. Oil Co.*, 300 U.S. 481 (1937).

169. Treas. Reg. § 1.357-1 (1955).

170. 3 MERTENS 587. See H.R. REP. No. 855, 76th Cong., 1st Sess. 19 (1939); H.R. REP. No. 855, 76th Cong., 1st Sess. 20 (1939).

money.¹⁷¹ In other words, in such situations, the assumption will be treated as "boot" unless the taxpayer proves the assumption did not have a tax avoidance purpose and was pursuant to a "bona fide business purpose."¹⁷²

If there is either: 1) an assumption of a liability, or 2) taking property subject to a liability, this would render the nonrecognition provisions applicable to a "B" (stock for stock) reorganization and "C" (acquisition of assets for stock) reorganization of no effect.¹⁷³ As to the "C" reorganization, such assumption, although permissible, is narrowly limited by section 368(a)(2)(B) when "boot" is received in addition to such assumption or acquisition.¹⁷⁴ When section 357 is not satisfied then the total amount of the liability assumed or the total amount of the liability on the property acquired would be considered "boot" and taxed as such.¹⁷⁵

If the adjusted basis of the property received in the exchange is less than the amount of the liabilities assumed, then the favorable tax treatment rendered by section 357 ceases to be effective and such excess of the liabilities over the adjusted basis of the property will be treated as capital gain or ordinary income depending on the characteristics of the assets involved.¹⁷⁶ The excess is derived by adding the amount of the liabilities assumed and the liabilities to which the property is subjected.¹⁷⁷

B. Proposed Amendments to Section 357.

The proposed amendments to section 357 do not make the extensive changes found in other sections. The proposals would make section 357(c) (taxing assumption of liability in excess of basis) inapplicable to intercorporate exchanges in the "D" (transfer of assets for stock) reorganization. The reason for this change lies in the proposed change in section 368(a)(D) (the "D" reorganization provision) which would now require the complete liquidation of the transferor corporation.¹⁷⁸

Section 357(c) is an exception to the general rule stated in section 357(a) that liabilities assumed will not be treated as "other property" or "boot." By virtue of section 357(c) if the liabilities assumed exceed the adjusted basis of the property acquired then such excess is "boot." Under the proposals to section 357(c) there is an exception grafted onto the above exception.¹⁷⁹ For example, if A the shareholder of X, the transferee, supplies the property transferred to X prior to the actual exchange then

171. Treas. Reg. § 1.357-1 (1955).

172. *Ibid.*

173. 3 MERTENS 591.

174. *Id.* at 592.

175. Treas. Reg. § 1.357-1(c) (1955).

176. 3 MERTENS 595. This rule applies in an exchange with a controlled corporation within section 351 and in a "D" reorganization.

177. *Id.* at 596.

178. Proposed Amendments § 22, p. 70-71.

179. *Id.* at 71.

any liability which A later assumes will not fall within the section 357(c) exception. However, in such a case, the liability assumed must have been the primary liability of the transferee immediately before the actual exchange.¹⁸⁰ The advisory group has stated this proposition in the following language:

"Section 357(c)(2)(B) has been added to state that section 357(c) is inapplicable where immediately before the exchange the liabilities constitute the primary obligation of the transferee corporation. This will make clear that section 357(c) does not apply, for example, in cases in which the property transferred has merely been put up by the shareholder as security for indebtedness of the transferee corporation prior to the transfer."

VII. PARTY TO A REORGANIZATION

A. *Present Law.*

The term "party to a reorganization" is set forth in section 368(b) and is of considerable importance since it is used in two of the non-recognition sections.¹⁸¹ Under the 1954 Code "a party to a reorganization" includes the following: 1) a corporation resulting from a reorganization, and 2) both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

Under the 1954 Code, section 368(b) provides that in a "C" (acquisition of assets for stock) reorganization when the acquiring corporation gives the voting stock of its parent as the consideration for the assets of the transferor, the term "party to a reorganization" includes the parent corporation whose stock was the consideration furnished for the assets. Similarly, that same section provides that in the case of an "A" (statutory merger) or "C" (acquisition of assets for stock) reorganization when the parent acquires the assets of the transferor for ultimate transfer to its controlled subsidiary, then the term "party to a reorganization" likewise includes that parent.

Only a corporation may be termed "a party to a reorganization." It has been held that if there is a syndicate¹⁸² or municipality¹⁸³ involved, then the term "party to a reorganization" would not encompass those terms. The real test of determining whether a corporation is a "party to a reorganization" would appear to be directly related with the "continuity of interest" test.¹⁸⁴

180. *Ibid.*

181. INT. REV. CODE OF 1954, §§ 354, 361. See also Treas. Reg. § 1.368-1(c) (1955).

182. *Tennessee, A. & G. Ry. Co.*, 13 T.C. 486, 493 (1949), *aff'd*, 187 F.2d 826 (6th Cir. 1951).

183. *Thomas Emery*, 8 T.C. 979 (1947), *aff'd*, 166 F.2d 27 (2d Cir. 1948).

184. 3 MERTENS 413-14.

B. Proposed "Party to a Reorganization."

In the proposed amendments there has been a decided change in the term "party to a reorganization." As previously noted under the 1954 Code, there could be no "B" (stock for stock) reorganization in the following instances: 1) if the consideration for the stock acquired was the stock of a corporation which was controlled by the acquiring corporation, 2) if only a part of the consideration was the parent's stock, and 3) if the stock acquired was transferred to a controlled subsidiary or a part thereof so transferred.

The proposals have recommended that the *Groman* and *Bashford* rule no longer be applicable to the "B" (stock for stock) reorganization just as the 1954 Code made it inapplicable to the "A" (statutory merger) and "C" (acquisition of assets for stock) reorganizations.¹⁸⁵ Such a proposal would achieve three results: 1) it would allow the acquiring corporation to give the stock of its parent as consideration for the stock of the transferor corporation; 2) it would now mean that both the acquiring corporation and the transferor corporation would be "parties to the reorganization;" 3) the parent in control of the acquiring corporation would likewise be considered "a party to the reorganization."¹⁸⁶

VIII. PLAN OF REORGANIZATION

Another term of importance in the reorganization provision is the term "plan of reorganization." The term has not been defined,¹⁸⁷ but there has been some attempt at definition in the regulations.¹⁸⁸ It has been held that the "plan of reorganization" need not be in writing nor must it be attended by any requirements of formality.¹⁸⁹ The "plan" is to be found in the prior negotiations and discussions that the parties have undertaken in relation to the transaction.¹⁹⁰ Incidentally, it is of interest to note that from the scope of the "plan of reorganization" it may be possible to determine who are the "parties to the reorganization."¹⁹¹

IX. THE STEP TRANSACTION DOCTRINE

Generally, to achieve effectively the status of a reorganization as defined in section 368(a), there are several steps which are undertaken.

185. Proposed Amendments § 26, p. 82.

186. *Ibid.*

187. 3 MERTENS 403.

188. Treas. Reg. § 1.368-1(c) (1955); Treas. Reg. § 1.368-2(g) (1955); Treas. Reg. § 1.368-3(a) (1955).

189. *C. T. Inv. Co. v. Commissioner*, 88 F.2d 582, 585 (8th Cir. 1937). *Ethel K. Lasser*, 26 T.C. 306 (1956); *James G. Murrin*, 24 T.C. 502 (1955). See also *Hortense A. Menefee*, 46 B.T.A. 865, 868 (1942).

190. *Transport Prod. Corp.*, 25 T.C. 853, 858, *aff'd*, 239 F.2d 859 (6th Cir. 1956).

191. *Robert Campbell*, 15 T.C. 312 (1929). See *Anheuser Busch, Inc.*, 40 B.T.A. 1100 (1939), *aff'd*, 115 F.2d 662 (8th Cir. 1940), *cert. denied*, 312 U.S. 699 (1941); *George D. Graham*, 37 B.T.A. 623 (1938).

This is due to the fact that a reorganization is generally a series of complex transactions. The several steps may be treated separately for tax purposes. Also, the transaction may be of such a nature that each step is so related to the prior step that, in effect, it is really a single transaction. For example, under the 1954 Code definition of the "B" (stock for stock) reorganization, a corporation may acquire some stock for cash, and some solely for voting stock. The two transactions or steps may be regarded as part of a common scheme and treated as a single transaction. If so regarded, the "solely for voting stock" requirement would be violated, and the transaction would not be a valid "B" (stock for stock) reorganization. If, however, the two steps are separate and distinct from one another and the second step is solely for voting stock, and further, that the acquiring corporation immediately after the acquisition controls the other corporation, then the "B" (stock for stock) reorganization would be effected and the desired tax treatment would be accomplished. The test to determine the tax consequences of the steps depends on the "mutual interdependence of the steps."¹⁹²

Another good example where the steps were treated as separate steps may be found in the *Minnie C. Brackett*¹⁹³ case. In that case, taxpayers transferred assets to a corporation which had recently been organized. The stockholders were paid by check which they then used to purchase the corporation's capital stock. The court held that this transaction was in reality a sale of assets for a profit rather than an exchange of assets for stock. Similarly, in the *Regal Shoe Co.*¹⁹⁴ case the taxpayer intended to acquire three corporations with their assets and business. He exchanged stock as consideration for the stock of the three corporations and subsequently used their stock to acquire their assets. The refusal of the Board to disregard the primary step and look upon the transaction as "C" (acquisition of assets for stock) reorganization, appears to be an erroneous result.

There have been cases where the separateness of each step in the transaction has been disregarded and the steps have been looked upon as a single transaction leading to a single desired result. For example, in *Love v. Commissioner*,¹⁹⁵ despite the fact that prior to the exchange of stock for stock there was a cash distribution in liquidation, the circuit court found a single transaction. The court decided that when all the steps were undertaken with a single purpose in mind, that is, a stock for stock reorganization ("B" reorganization), then the whole transaction

192. A.C.F. — *Brill Motors Co. v. Commissioner*, 189 F.2d 704 (3d Cir. 1951), cert. denied, 342 U.S. 886 (1951). See also Rev. Rul. 54-65, 1954-1 CUM. BULL. 101. See also *Dixie Portland Flour Co.*, 31 T.C. 641 (1958): "Were the steps so mutually interdependent that the legal relationships created by one would have been fruitless without the completion of the series?"

193. 19 B.T.A. 1154 (1930).

194. 1 B.T.A. 896 (1925).

195. 113 F.2d 236 (3d Cir. 1940).

will be looked upon as a single transaction. Further, each step will be considered merely a step in pursuance of a common plan. Similarly, in the *Von's Investment Company*¹⁹⁶ case the court found a single common scheme. The fact that some of the transferors made their exchanges at a later time than others, and that some of the transferors received their shares in the controlled corporation before the others, did not serve to defeat the common scheme.

X. BASIS

A. *Basis to distributees*

1. PRESENT LAW

The last sections of the reorganization provisions with which this article will deal are section 358 and section 362.¹⁹⁷

The present section 358 deals with the "basis to distributees." The section provides that in an exchange where sections 351, 354, 355, 356, 361, or 371(b) apply, the basis of that property which those sections allow to be received shall be the same as that of the property which is transferred.¹⁹⁸ That basis, however, in section 358(a)(1)(A) is to be *decreased* by the following: 1) the fair market value of "boot" but not money which the taxpayer receives, plus 2) the amount of money received and 3) the amount of taxpayer's recognized loss. Under section 358(a)(1)(B) the basis is *increased* by the following: 1) that amount which received dividend treatment, plus 2) the amount of recognized gain, excluding of course, that amount which was treated as a dividend.

As to the other property received under section 358(a)(2), the basis of such property shall be the fair market value of such other property. In section 358(b) it is expressly provided that the Regulations may allocate the above determined basis among those properties which, for non-recognition purposes, may be received. Further, in the exchanges to which section 355 applies "or so much of section 356 as relates to section 355," then such allocation shall be made not only among the non-recognition property but also among those stocks and securities which the distributing corporation retained.

Section 358(d) provides that for basis purposes section 357 (assumption of liabilities or acquisition of property subject to a liability) shall be treated as money received by the taxpayer. However, section 358(e) qualifies the basis provision by stating that this section is not applicable in a case where a corporation acquired property in consideration for its stocks or securities.

196. 92 F.2d 861 (9th Cir. 1937), *reversing* 33 B.T.A. 30 (1935). See also 111 F.2d 440 (9th Cir. 1940), *affirming* 39 B.T.A. 1141 (1939).

197. For a clear and concise description of the operation of basis in reorganizations, see McDonald & Willard 901-903.

198. INT. REV. CODE OF 1954, § 358(a)(1). See Treas. Reg. § 1.358-1 (1955).

2. PROPOSED AMENDMENTS

Under the proposed amendments to section 358 the first change is to delete the present section 358(a)(1)(B)(i) from the section since it is inapplicable to section 351 (corporate organization) and 361 (tax treatment to the corporation) exchanges. The new section 358(a) is to apply *only* to section 351 and 361 exchanges.¹⁹⁹

Another modification is found in the new section 358(c)²⁰⁰ which provides, as does the present section 358(d), that, for basis purposes the assumption of liability or the acquiring of property subject to a liability, is to be treated as money received by the taxpayer. However, if this liability just prior to the exchange was the primary obligation of the other party, it will not be treated as money received. This change according to the proposals is consistent with the recommended changes in section 357(c).²⁰¹

Present section 358(c)²⁰² has been amended in the proposed section 358(f) to insure that where a corporation exchanges its own stock for property in a reorganization, then the basis of such property should be governed by the rules of section 362. The basis to be utilized is that of the corporation from which the property was acquired, and not the basis of the stock given in exchange thereof.²⁰³

B. Basis to Corporations

1. PRESENT LAW

The last section of the reorganization provision under discussion is section 362 which deals with the basis to the corporation.

Section 362(a) provides that if a corporation acquires property on or after June 22, 1954 under the following circumstances: 1) in a transaction qualifying under section 351 or 2) as paid-in surplus or 3) as a contribution to capital, then the basis to be used is that of the transferor, increased by the amount of gain the transferor recognized on the transfer.

In section 362(b) it is expressly provided that a corporation which acquires property in a reorganization shall take the transferor's basis, which is to be increased by any gain recognized by the transferor. Unless the transferee acquires stock or securities in exchange for its own stock or

199. Proposed Amendments § 23, p. 71.

200. New § 358(e): "Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange. This subsection shall not apply to any liability which, immediately before the exchange, is the primary obligation of such other party."

201. Proposed Amendments § 23, p. 72. See discussion on proposed changes to Section 357(c) *supra*.

202. New § 358(f): "This section shall not apply in the determination of the basis of property if section 362 is applicable in determining the basis of such property."

203. Proposed Amendments § 23, p. 72.

securities from a transferor who is a party to the reorganization, section 362(b) will not apply.

2. PROPOSED AMENDMENTS

The principal change in section 362 is the addition of a new section 362(b)(2).²⁰⁴ This new section is designed to take care of adjustments to the basis of subsidiary's stock which is now held by the parent when, in an "A" (statutory merger), "B" (stock for stock), or "C" (acquisition of assets for stock) reorganization, "stock or property is acquired by a subsidiary in exchange for stock issued by its parent."²⁰⁵ This section also would be applicable when after the parent acquires the stock of property for its own stock, it transfers such property or stock acquired to its own subsidiary.²⁰⁶ In such a case there probably will be no consideration passing from the subsidiary to the parent. Appropriate basis adjustments must nevertheless be made and the proposals have deemed it wise not to specify detailed rules for such adjustments, but rather to leave this within the province of the Regulations.²⁰⁷

XI. CONCLUSIONS

The whole concept of the reorganization scheme appears to be that corporations should be allowed to freely alter their organizational structure for tax purposes provided, of course, that the corporation is, in effect, the same entity it was before, *i.e.*, the change was merely a change in form and *not* in substance. The proposed amendments in seeking to further this concept have made marked changes where practice has proved necessary.

Under the 1954 Code it is very difficult to reorganize, especially in the "B" (stock for stock) type reorganization, due to the "solely for voting stock" requirement. This requirement is also present in the "C" (acquisition of assets for stock) reorganization.²⁰⁸ In a "B" (stock for stock) reorganization, for instance, a corporation might err in the planning stages and make the whole reorganization appear as a single transaction. The presence of any property other than "solely voting stock" when such an error is made, would destroy the reorganization regardless of the fact that the real aim of the corporation is to effect a valid "B" (stock for stock) reorganization. The proposals have revolutionized this

204. New § 362(b)(2): "In the case of an acquisition referred to in paragraph (1), if all or part of the consideration received by the transferor consists of stock or securities of a corporation which is in control of the acquiring corporation, then, under regulations prescribed by the Secretary or his delegate, proper adjustment shall be made to the basis to the controlling corporation of the stock or securities held by it in the acquiring corporation.

205. Proposed Amendments § 25, p. 74.

206. *Ibid.*

207. *Ibid.*

208. See INT. REV. CODE OF 1954, § 368(a)(1)(B), (C).

phase of the reorganization by no longer requiring "solely for voting stock" as a condition precedent to a "B" (stock for stock) or "C" (acquisition of assets for stock) reorganization.²⁰⁹ As the advisory group itself concluded, the "solely for voting stock" requirement unduly hampers the operation of the reorganization provision rather than being of assistance.²¹⁰ The real "continuity of interest" test should be economic "continuity of interest," rather than the right to vote.²¹¹

A significant change effected by the destruction of the voting stock requirement allows the "C" (acquisition of assets for stock) reorganization to be achieved by "creeping acquisition" just as the "B" (stock for stock) reorganization under the 1954 Code could be effectuated by a "creeping control."²¹²

Finally a welcome change is the destruction of the *Groman* and *Bashford* rule as applied to the "B" type reorganization.²¹³ This result could have been forecasted due to the change the 1954 Code effected by making that rule inapplicable to the "A" (statutory merger) and "C" (acquisition of assets for stock) reorganizations. It might even be said that the 1954 Code itself should have taken care of this problem.

BRUCE SPENCER REZNICK

APPENDIX A

This Appendix encompasses the pertinent provisions of the 1954 Internal Revenue Code dealing with corporate reorganization.

Sec. 354(a)

(a) General Rule.

(1) In General.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) Limitation. Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

209. See New § 368(a)(1)(B)(i) and New § 368(a)(1)(C)(i).

210. Proposed Amendments § 26, p. 75.

211. *Id.* at 76.

212. New § 368(a)(1)(C)(i).

213. Proposed Amendments § 26, p. 81-82.

(3) Cross Reference.—For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

Sec. 354(b)

(b) Exception.—

(1) In General.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless,

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

(2) Cross Reference.—For special rules for certain exchanges in pursuance of plans of reorganization within the meaning of section 368(a)(1)(D), see section 355.

Sec. 356(a)

(a) Gain on Exchanges.—

(1) Recognition of gain.—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) Treatment as dividend.—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

Sec. 356(b)

(b) Additional consideration received in certain distributions. If—(1) section 355 would apply to a distribution but for the fact that

(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money, then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

Sec. 356(c)

(c) Loss.—If—

(1) section 354 would apply to an exchange, or section 355 would apply to an exchange or distribution, but for the fact that

(2) the property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange or distribution shall be recognized.

Sec. 356(d)

(d) Securities as other property.—For purposes of this section.—

(1) In General.—Except as provided in paragraph (2), the term “other property” includes securities.

(2) Exceptions.—

(A) Securities with respect to which nonrecognition of gain would be permitted.—The term “other property” does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.

(B) Greater principal amount in section 354 exchange.—If—(i) in an exchange described in section 354 (other than subsection (c) thereof), securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered, then, with respect to such securities received, the term “other property” means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (C), if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

(C) Greater Principal Amount in section 355 Transaction.—If, in an exchange or distribution described in section 355, the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities in the distributing corporation which

are surrendered, then, with respect to such securities received, the term "other property" means only the fair market value of such excess.

Sec. 357(a)

(a) General Rule.—Except as provided in subsections (b) and (c), if—

(1) the taxpayer receives property which would be permitted to be received under section 351, 361, 371, or 374 without the recognition of gain if it were the sole consideration, and (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351, 361, 371, or 374, as the case may be.

Sec. 357(b)

(1) In General.—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose, then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351, 361, 371, or 374 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) Burden of proof.—In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

Sec. 357(c)

(1) In General.—In the case of an exchange—

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D), if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered

as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) Exceptions.—Paragraph (1) shall not apply to any exchange to which—

- (A) subsection (b) (1) of this section applies, or
- (B) section 371 or 374 applies.

Sec. 358(a)

(a) General Rule.—In the case of an exchange to which section 351, 354, 355, 356, 361, or 371(b) applies—

(1) Nonrecognition Property.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer, and

(iii) the amount of loss to the taxpayer which was recognized on such exchange, and

(B) increased by—

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) Other Property.—The basis of any other property (except money) received by the taxpayer shall be its fair market value.

Sec. 358(b)

(b) Allocation of basis.

(1) In General.—Under regulations prescribed by the Secretary or his delegate, the basis determined under subsection (a) (1) shall be allocated among the properties permitted to be received without the recognition of gain or loss.

(2) Special Rule for section 355.—Omitted

Sec. 358(c) Omitted

Sec. 358(d)

(d) Assumption of liability.—Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

Sec. 358(e)

(e) Exception.—This section shall not apply to property acquired by a corporation by the issuance of its stock or securities as consideration in whole or in part for the transfer of the property to it.

Sec. 361(a)

(a) General Rule.—No gain or loss shall be recognized if a corporation a party to reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

Sec. 361(b)

(b) Exchanges not solely in kind.—

(1) Gain.—If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also other property or money, then—

(A) if the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(B) if the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(2) Loss.—If subsection (a) would apply an exchange but for the fact that the property received in exchange consists not only of property permitted by subsection (a) to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

Sec. 362(a)

(a) Property Acquired by Issuance of Stock or as Paid-In Surplus.—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

Sec. 362(b)

(b) Transfers to Corporations.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

Sec. 362(c)

(c) Special Rule for Certain Contributions to Capital.—

(1) Property other than money.—Notwithstanding subsection (a)

(2), if property other than money.—

(A) is acquired by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such, then the basis of such property shall be zero.

(2) Money.—Notwithstanding subsection (a) (2), if money—

(A) is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such, then the basis of any property acquired with such money during the 12 month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required

by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary or his delegate.

Sec. 368(a)

(a) Reorganization.—

(1) In General.—For purposes of parts I and II and this part, the term “reorganization” means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

(2) Special Rules Relating to Paragraph (1)—

(A) If a transaction is described in both paragraph (1) (C) and paragraph (1) (D), then, for purposes of this subchapter, such transaction shall be treated as described only in paragraph (1) (D).

(B) If—

(i) one corporation acquires substantially all of the properties of another corporation,

(ii) the acquisition would qualify under paragraph (1) (C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1) (C), property of the other corporation having a fair market value which is at least 80% of the fair market value of all of the property of the other corporation,

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1) (C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation, and the amount of any liability to which any property acquired by the acquiring corporation is subject, shall be treated as money paid for the property.

(C) A transaction otherwise qualifying under paragraph (1) (A) or paragraph (1) (C) shall not be disqualified by reason of the fact that part of all of the assets which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets.

Sec. 368(b)

(b) For the purposes of this part, the term "a party to a reorganization" includes—

(1) a corporation resulting from a reorganization, and

(2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

In the case of a reorganization qualifying under paragraph (1) (C) of subsection (a), if the stock exchanged for the properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to reorganization" includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1)(A) or (1)(C) of subsection (a) by reason of paragraph (2)(C) of subsection (a), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets are transferred.

Sec. 368(c)

(c) For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

APPENDIX B

This appendix encompasses the proposed amendments to the pertinent provisions of the 1954 Internal Revenue Code dealing with corporate reorganization.

Sec. 19. Exchanges of Stock and Securities in Certain Reorganizations—
Amendment of section 354.

Section 354 is amended to read as follows:

“Sec. 354. Exchanges of Stock and Securities in Certain Reorganizations.

“(a) General Rule.—

“(1) In general.—No gain or loss shall be recognized (and no amount shall be includible in income) if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

“(2) Limitation.—Paragraph (1) shall not apply if—

“(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or any such securities are received and no such securities are surrendered, or

“(B) in the case of an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), the corporation pursuant to the plan distributes to its shareholders in exchange stock in more than one corporation a party to the reorganization.

Sec. 21. Receipt of Additional Consideration—Amendment of section 356.
Section 356 is amended to read as follows:

“Sec. 356. Receipt of Additional Consideration.

“(a) Exchanges of Stock and Securities.—

“(1) General rule.—If—

“(A) section 354 would apply to an exchange made “pursuant to a plan of reorganization (other than a reorganization under section 368(a)(1)(D), or if section 355 or 371(b) would apply to an exchange, but for the fact that

“(B) the property received in the exchange consists not only of property permitted by section 354, 355, or 371(b) to be received without the recognition of gain or loss but also of other property or money,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) the recipient except to the extent provided in subsection (b).

“(2) Exchanges pursuant to section 368(a)(1)(D) reorganizations.—If—

“(A) section 354 would apply to an exchange made pursuant to a plan of reorganization under section 368(a)(1)(D) but for the fact that

“(B) the property received in the exchange

“(i) consists not only of property permitted by section 354 to be received without the recognition of gain or loss, but also of other property or money, or

“(ii) consists entirely of other property or money,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) the recipient except to the extent provided in subsection (b).

“(b) Exception.—

“(1) Other property or money received in exchange for stock.—

“(A) Distributions having effect of dividends, redemptions of stock, or partial liquidations.—So much of such other property or money received in exchange for stock as—

“(i) has the effect of a distribution of a dividend shall be treated as a dividend to the recipient as provided in section 301, but in an amount not in excess of the recipient's ratable share of the undistributed earnings and profits of the corporation referred to in section 316(a)(1) or (2);

“(ii) has the effect of a distribution in redemption of stock under section 302(b) or 303 shall be treated as a distribution to the recipient as provided in section 302(a) or 303(a); and

“(iii) has the effect of a distribution in partial liquidation under section 346 shall be treated as a distribution to the recipient as provided in section 331(a)(2) and (b).

If clause (ii) or (iii), or both, are applicable, then in determining gain or loss (as the case may be) to the recipient, the adjusted basis of the stock in exchange for which such other property or money referred to in clauses (ii) and (iii) is considered to be received shall be that part of the adjusted basis of all the stock exchanged in the transaction by the recipient as the fair market value of such other property or money referred to in clauses (ii) and (iii) bears to the total fair market value of all the property and money received on the exchange.

“(B) Remainder of other property or money received in exchange for stock.—The remainder, if any, of such other property or money

received in exchange for stock shall be treated as a distribution to which section 301(c)(2) and (3) applies.

“(2) Other property or money received in exchange for securities.—

“(A) Amounts having effect of payment of interest.—So much of such other property or money received in exchange for securities as has the effect of a payment of interest accrued thereon since the date of acquisition of the securities by the recipient (or by a person from whom the recipient acquired the securities in a transaction in which no gain or loss was recognized) shall, to the extent of its fair market value, be treated as interest income to the recipient as provided in section 61(a)(4).

“(B) Remainder of other property or money received in exchange for securities.—The remainder of such other property or money received in exchange for securities shall, to the extent of its fair market value, be applied against and reduce the adjusted basis of the property permitted by section 354, 355, or 371(b) to be received without the recognition of gain or loss, and if in excess of such basis, such excess shall be treated as gain from the sale or exchange of property.

“(c) Additional Consideration Received in Certain Distributions.—
If—

“(1) section 355 would apply to a distribution made without the surrender of any stock or securities of the distributing corporation, but for the fact that

“(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

“(d) Securities as Other Property.—For purposes of this section—

“(1) In general.—Except as provided in paragraph (2), the term ‘other property’ includes securities.

“(2) Exceptions.—

“(A) Securities with respect to which nonrecognition of gain would be permitted.—The term ‘other property’ does not include securities to the extent that, under section 354, 355, or 371(b) such securities would be permitted to be received without the recognition of gain.

“(B) Greater principal amount in section 354, 371(b), and 355 Transactions.—If in an exchange described in section 354 (other than subsection (b) thereof) or 371(b) or an exchange or distribution described

in section 355, securities are received in a greater principal amount than the securities (if any) surrendered, then, with respect to such securities received, the term 'other property' means only the fair market value of such excess. For purposes of this subparagraph, if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

“(e) Exchanges for Section 306 Stock.—Notwithstanding any other provision of this section, if

“(1) any of the other property (or money) is received in exchange for section 306 stock, and

“(2) section 306(a) would have applied if the amount received on such exchange had consisted solely of money,

an amount equal to the fair market value of such other property (or the amount of such money) shall be treated as an amount realized to which section 306(a) applies.

“(f) Stock in Two or More Corporations Distributed in Certain Reorganizations.—If—

“(1) section 354 would apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D) but for the fact that

“(2) stock in more than one corporation a party to the reorganization is distributed by the transferor corporation pursuant to the plan,

then, for purposes of subsection (a) and (b) of this section the stock so distributed (of any such corporation) which has a fair market value greater than the stock so distributed of any other such corporation or corporations shall be treated as property permitted by section 354 to be received without the recognition of gain or loss, and the stock of such other corporation or corporations shall be treated as other property.”

Sec. 22. Assumption of Liability—Amendment of Section 357.

Section 357(c) is amended to read as follows:

“(c) Liabilities in Excess of Basis.—

“(1) In general.—In the case of an exchange to which section 351 applies, if the sum of the amount of liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then, the meaning of section 368(a)(1)(D) or a plan described in section 351(b)(1)(B), such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

“(2) Exceptions.—Paragraph (1) shall not apply—

“(A) to any exchange to which—

“(i) subsection (b)(1) of this section applies; or

“(ii) section 371 or 374 applies, or

“(B) to any liabilities which, immediately before the exchange, are the primary obligation of the transferee.”

Sec. 23. Basis to Distributees—Amendment of Section 358.

Section 358 is amended to read as follows:

“Sec. 358. Basis to Distributees.

“(a) Property Received in Exchanges Under Section 351 or 361.—In the case of an exchange to which section 351 or 361 applies—

“(1) Nonrecognition property.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

“(A) decreased by—

“(i) the fair market value of any other property (except money) received by the taxpayer, and

“(ii) the amount of money received by the taxpayer, and

“(B) increased by the amount of gain to the taxpayer which was recognized on such exchange.

“(2) Other property.—The basis of any other property (except money) received by the taxpayer shall be its fair market value.

“(b) Property Received in Exchanges Under Section 354, 355, 356, or 371(b).—In the case of an exchange to which section 354, 355, 356, or 371(b) applies—

“(1) Nonrecognition property received in exchange for stock.—The basis of property permitted to be received under such section without the recognition of gain or loss, which is received by the taxpayer in exchange for stock, shall be the same as that of the stock exchanged, decreased by—

“(A) that part of the basis of the stock exchanged which is applied in the determination of gain or loss under section 356(b)(1)(A)(ii) and (iii) (relating to distributions which have the effect of a distribution in redemption of stock or a partial liquidation), and

“(B) that part of the distribution of other property and money, received in exchange for stock, which under section 356(b)(1)(B) is treated as a distribution to which section 301(c)(2) applies.

“(2) Nonrecognition property received in exchange for securities.—The basis of property permitted, to be received under such section without the recognition of gain or loss, which is received by the taxpayer in exchange for securities, shall be the same as that of the securities exchanged, decreased by the amount which under section 356(b)(2)(B) is applied in reduction of basis.

“(3) Other property.—The basis of any other property (except money) received by the taxpayer shall be its fair market value, except that—

“(A) if the taxpayer is a corporation and the provisions of section 356(b)(1)(A)(i) or 356 (b)(1)(B) are applicable to the receipt of such property, its basis shall be determined in accordance with the provisions of section 301(d) (relating to the basis of property received by distributees); and

“(B) if the provisions of section 356(b)(1)(A)(ii) or (iii), or both, are applicable to the receipt of such property, its basis shall be determined in accordance with the provisions of section 334(a) (relating to basis of property received in certain liquidations and redemptions).

“(c) Allocation of Basis.—

“(1) In general.—Under regulations prescribed by the Secretary or his delegate, the basis determined under subsection (a)(1), (b)(1), or (b)(2) shall be allocated among the properties permitted to be received without the recognition of gain or loss.

“(2) Special rule for section 355.—In the case of an exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then in making the allocation under paragraph (1) of this subsection, there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation which are retained, and the allocation of basis shall be made among all such properties.

“(d) Section 355.—Transactions Which Are Not Exchanges.—For purposes of this section, a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange, and for such purposes the stock and securities of the distributing corporation which are retained shall be treated as surrendered, and received back, in the exchange.

“(e) Assumption of Liability.—Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on

the exchange. This subsection shall not apply to any liability which, immediately before the exchange, is the primary obligation of such other party.

“(f) Exception.—This section shall not apply in the determination of the basis of property if section 362 is applicable in determining the basis of such property.”

Sec. 24. Nonrecognition of Gain or Loss to Corporations—Amendment of Section 361 is amended to read as follows:

“Sec. 361. Nonrecognition of Gain or Loss to Corporations in Reorganizations.

“(a) General Rule.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

“(b) Exchanges Not Solely in Kind.—If subsection (a) would apply to an exchange made pursuant to a plan of reorganization but for the fact that the property received in exchange consists not only of property permitted by subsection (a) to be received without the recognition of gain or loss, but also of other property or money, or consists entirely of other property or money, then—

“(1) In case of gain.—Gain (if any) to the corporation receiving such other property or money shall be recognized, but in an amount not greater than the amount by which—

“(A) such gain, or the sum of such money and the fair market value of such other property so received, whichever is the lesser, exceeds

“(B) the sum of

“(i) the amount of money, and

“(ii) the fair market value of such other property so received which is distributed by the corporation in pursuance of the plan of reorganization; and

“(2) In case of loss.—No loss from the exchange shall be recognized.

“(c) Exchange of Parent's Stock by Controlled Corporation.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges, in pursuance of the plan of reorganization, stock of a corporation which controls it solely for property or stock in another corporation a party to the reorganization.”

Sec. 25. Basis to Corporations—Amendment of Section 362.

Section 362(b) is amended to read as follows:

“(b) Transfers to Corporations.—

“(1) Property acquired in connection with a reorganization.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

“(2) Adjustment of basis of stock of acquiring corporation held by controlling corporation.—In the case of an acquisition referred to in paragraph (1), if all or part of the consideration received by the transferor consists of stock or securities of a corporation which is in control of the acquiring corporation, then, under regulations prescribed by the Secretary or his delegate, proper adjustment shall be made to the basis to the controlling corporation of the stock or securities held by it in the acquiring corporation.

“(3) Exception.—This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.”

Sec. 26. Definitions Relating to Corporate Reorganizations.—Amendment of Section 368.

Section 368 is amended to read as follows:

“Sec. 368. Definitions Relating to Corporate Reorganizations.

“(a) Reorganization.—

“(1) In general.—For purposes of parts I and II and this part, the term ‘reorganization’ means—

“(A) a transfer of the properties of one corporation to another corporation by statutory merger or consolidation, if either—

“(i) 66 2/3 percent or more of the consideration received by the shareholder in exchange for such stock, measured by fair market value, such corporation), measured by fair market value, consists of stock of the acquiring corporation, or

“(ii) immediately after the transfer the shareholders of the transferor corporation are in control (substituting a 50 percent requirement for the 80 percent requirement contained in subsection (c)) of the acquiring corporation;

“(B) a transfer by a shareholder of one corporation of stock of such corporation to another corporation if—

“(i) 66 2/3 percent or more of the consideration received by the shareholder in exchange for such stock, measured by fair market value, consists of stock of the acquiring corporation, and

“(ii) the acquiring corporation is in control of the other corporation immediately after the acquisition, or acquires such control within six months after the acquisition;

“(C) a transfer by one corporation of substantially all of its properties to another corporation if—

“(i) 66 2/3 percent or more of the consideration received in exchange therefor and distributed to the shareholders of the transferor corporation, measured by fair market value, consists of stock of the acquiring corporation,

“(ii) the transferor corporation is completely liquidated as a part of the plan pursuant to which the transfer of properties is made, and

“(iii) neither the transferor nor any of its shareholders nor any combination thereof is in control (substituting a 50 percent requirement for the 80 percent requirement contained in subsection (c), of the acquiring corporation immediately after the transfer;

“(D) a transfer of all or a part of the properties of one corporation to another corporation if—

“(i) immediately after the transfer the corporation whose properties are transferred, or one or more of its shareholders, or any combination thereof, is in control (substituting a 50 percent requirement for the 80 percent requirement contained in subsection (c)) of the acquiring corporation,

“(ii) the corporation whose properties are transferred is completely liquidated as a part of the plan pursuant to which the transfer is made (whether such complete liquidation precedes, accompanies, or follows the transfer), and

“(iii) no part of such plan constitutes a distribution of stock or securities to which section 355 (or so much of section 356 as relates to section 355) applies;

“(E) a recapitalization; or

“(F) a mere change in identity, or place of organization of a corporation, however effected.

“(2) Special rules relating to paragraph (1).—

“(A) Existence of control.—The requirements of paragraphs (1)(A) (ii), (1)(B)(ii), and (1)(D)(i) with respect to the existence of control shall be satisfied if such control exists at the times specified therein whether or not such control previously existed.

“(B) Prior ownership of stock in transferor.—For purposes of paragraph (1)(A) and (C), if stock of the transferor corporation is owned by the acquiring corporation at the time of the transaction, then the determination of whether 66 2/3 percent or more of the consideration received by the shareholders of the transferor corporation consists of stock of the acquiring corporation shall be made by assuming that the acquiring corporation exchanged its stock for the assets of the transferor corporation attributable to stock of the transferor corporation previously owned by the acquiring corporation, and that such stock of the acquiring corporation was thereupon distributed by the transferor corporation in pursuance of the plan.

“(C) Shareholders.—As used in paragraphs (1)(A), (1)(C), and (1)(D) the term ‘shareholders’ includes persons who were shareholders immediately before the transfer or immediately before the liquidation referred to therein.

“(b) Party to a Reorganization.—For purposes of this part, the term ‘a party to a reorganization’ includes—

“(1) a corporation resulting from a reorganization, and

“(2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

“(c) Control.—For purposes of part I (other than sections 302 and 304), part II, and this part, the term ‘control’ means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

“(d) Stock.—For purposes of this part, except subsection (c) of this section, the term ‘stock’ includes rights to acquire stock.

“(e) Special Rules Relating to Subsections (a) and (b).—

“(1) Stock of parent corporation received in the exchange.—A transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) of subsection (a) shall not be disqualified by reason of the fact that all or part of the consideration received in exchange for the stock or properties transferred consists of stock of a corporation which is in control of the acquiring corporation. In such event the term ‘acquiring corporation’ as used in subsection (a) and the term ‘a party to a reorganization’ as defined in subsection (b) shall include not only the acquiring corporation but also the corporation which is in control of the acquiring corporation.

“(2) Transfers to subsidiaries of stock are properties acquired.—A transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) of subsection (a) shall not be disqualified by reason of the fact that all or part of the stock or properties acquired by the acquiring corporation are, in pursuance of the plan, transferred to a corporation controlled by it. In such event the term ‘acquiring corporation’ as used in subsection (a) and the term ‘a party to a reorganization’ as defined in subsection (b) shall include not only the acquiring corporation but also the corporation to which the acquiring corporation so transfers such stock or properties.”